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Anti-Williamson: a Marxian critique of New Institutional Economics

Daniel Ankarloo* and Giulio Palermo*

New institutional economics explains capitalist institutions by means of neoclassical tools. This method consists of introducing non-market institutions as solutions to market failures. The explicit or implicit assumption is that 'in the beginning there were markets'. In this paper, we criticise this conception inherited from neoclassical economics by focusing on Williamson's theory. First, we discuss Williamson's speculative method, which idealises the market and presents it as natural and universal. We then suggest that Williamson's categories, his method and conception are themselves products of bourgeois ideology. In this sense, we conclude, Williamson himself is ultimately an 'institution of capitalism'.

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I assume, for expositional convenience, that 'in the beginning there were markets'. (Williamson, 1975, p. 21)

Do not let us go back to a fictitious primordial condition as the political economist does, when he tries to explain. Such a primordial condition explains nothing. He merely pushes the question away into a grey nebulous distance. He assumes in the form of fact, of an event, what he is supposed to deduce . . . Theology in the same way explains the origin of evil by the fall of man: that is, it assumes as a fact, in historical form, what has to be explained. (Marx, 1964, p. 107)

The assumption that 'in the beginning there were markets' characterises all of New Institutional Economics (NIE) and is explicit in Oliver E. Williamson's transaction cost economics. Williamson states that the choice of initial conditions serves uniquely to stress some particular aspects of the relations among the institutions of capitalism, but does not influence their theoretical understanding because the use of comparative statics as a method of analysis of institutional evolution leads to the identification of the same institutional configuration independently of the initial conditions.

But, as we shall argue in this paper, the statement that 'in the beginning there were markets' is not a matter of expositional convenience, but one of theoretical consistency. The assumption of a primordial system of pure markets contains all the contradictions of the NIE approach to the study of the institutions of capitalism and is itself the product of an idealised vision of capitalist economic relations. The critique of Williamson's definition of

Manuscript received 12 March 1999; final version received 14 June 2002.
Address for correspondence: Dr G. Palermo, Department of Economics, University of Brescia, via S. Faustino 74B 25122 Brescia, italy; email: palermo@eco.unibs.it
*Malmö University, University of Brescia, Sweden, respectively.

the problem, method and conception enclosed in the assumption that in the beginning there were markets, not only points to the origins of the inner contradictions of the NIE research programme, but also suggests that Williamson, with his ideological understanding of the nature of capitalist institutions as efficient solutions to market failures, is ultimately himself an institution of capitalism.

This essay is structured as follows. In Section 1, we present Williamson's framework for the analysis of the institutions of capitalism. Next, we scrutinise the logic of Williamson's approach to the problem of the nature of capitalist institutions. Here we discuss the neoclassical roots of NIE, pointing out the necessity, within the neoclassical logic, to assume at least one institution as a primordial condition, and the ideological jump of NIE in its identification of such a primordial condition with a system of pure markets. Section 3 analyses the method of NIE through a criticism of Williamson's theory of efficiency of capitalist institutions and his idealistic approach to economic history. An examination of the internal consistency of Williamson's starting point of a pure market system follows, where we discuss the conception of capitalist institutions that underlies this assumption—a conception that leads him to consider the institutions of capitalism as substitutes for one another, rather than as complementary. We close with a Marxian answer to the problems of NIE and outline how the question of the institutions of capitalism can be developed within a Marxian perspective.

1. Williamson's market-hierarchies framework

Williamson's work is the most organic attempt to approach the problem of economic institutions within NIE. The author starts with the theoretical premise that 'in the beginning there were markets' (Williamson, 1975, p. 21) and, from this assumption, through successive exercises in comparative statics, he explains the economic role of other institutions. The general method consists of introducing non-market institutions every time the market fails to allocate resources efficiently. The economic institutions of capitalism (market and firms in particular) are thus considered explicitly as alternative tools for the same end (to complete transactions), and they are analysed for their allocative properties.

> The general approach to economic organization employed here can be summarized compactly as follows: (1) Markets and firms are alternative instruments for completing a related set of transactions; (2) whether a set of transactions ought to be executed across markets or within a firm depends on the relative efficiency of each mode. (Williamson, 1975, p. 8)

As a theoretical reference, the system of pure markets is defined in a context of zero transaction costs.[1] In such an ideal context, as is well known, there can be market failures; but Williamson does not develop the analysis of such failures. Instead, the definition of a zero transaction costs context has only a *negative* role in the construction of Williamson's framework; its definition serves uniquely as a point of reference to define contexts of positive transaction costs.[2] Williamson focuses explicitly only on those failures caused by transaction costs, without considering other kinds of market failures (Williamson, 1975, p. 20).

[1] Transaction costs are never defined in Williamson's work. Quoting the (not very precise) definition of K. J. Arrow (1969, p. 48), Williamson (1985, p. 18) refers to the 'costs of running the system'; later on (Williamson, 1985, p. 19), he defines transaction costs as 'the equivalent of friction in physical systems'.

[2] As a matter of fact, such an expedient is not sufficient to make Williamson's definitions more precise, since the zero transaction costs context itself is never rigorously defined.

Williamson introduces the assumption of a system of pure markets as the starting point for an explanation of the institutions of capitalism as an expositional device which, according to the author, is irrelevant from the viewpoint of the analytical results. Indeed, he observes, one may well assume that 'in the beginning there was central planning' and the focus would simply shift from market failures to planning failures. In any case, the use of comparative statics ensures that the same result would occur, since the efficient institutional arrangements do not depend on initial conditions. The institutional starting point, as Williamson (1985, p. 21) notes, affects the results of the framework only in case of equal efficiency, since the general idea is that an institution is substituted only if a *more* efficient one emerges.

However, Williamson's theory is more ambitious. Its objective is to explain the institutions of capitalism as the result of an evolutionary process. Williamson, thus, introduces the Pareto efficiency principle as the explanatory key to institutional evolution. After defining the initial starting point as a system of pure markets in which there are no hierarchical relations, Williamson explains the emergence of hierarchies in the evolution of capitalist institutions by saying that only Pareto-efficient institutions emerge and survive. This story is based on the idea of free intentionality intrinsic to human action: institutional evolution proceeds towards higher and higher degrees of efficiency as long as individual interactions take place *spontaneously*, *without coercion*.

The 'market and hierarchies' framework for the analysis of the institutions of capitalism is built on three theoretical categories: (1) opportunism, (2) bounded rationality and (3) asset specificity. The simultaneous presence of (1), (2) and (3) prevents the market from allocating resources efficiently.[1] Market failures, under given conditions, can be reduced by means of hierarchical organisations (such as firms).

The advantages of hierarchy over the market stem from the fact that hierarchy (1) attenuates the problems stemming from bounded rationality (by facilitating adaptive sequential decision-making processes in situations in which contracts on the contingent states of nature are not possible and spot markets are risky), (2) attenuates opportunism (both by means of the authoritarian mechanism and by stimulating solidarity), and (3) reduces bargaining costs arising from asset specificity (both through the authoritarian principle and by generating convergent expectations between the parties) (Williamson, 1975, p. 40).

The benefits of markets with respect to hierarchy stem from the incentive mechanism of the competitive principle, and the growing diseconomies associated with hierarchical organisation (Williamson, 1975, ch. 7).

Starting from a system of pure markets, firms are explained by determining the conditions that make a centralised organisational structure more efficient than the market. Once hierarchy is introduced, the (virtual) process of centralisation proceeds until economic benefits exceed economic costs; in this way Williamson's framework explains, not only the nature of the firm, but also its boundaries, since the optimum degree of centralisation defines the optimal extension of the firm.[2] Thus, if firms and markets coexist, it is

[1] Lacking one of the three factors, the market can still allocate resources efficiently *vis-à-vis* the firm: (1) without bounded rationality, all future potential problems can be solved once and for all and opportunism and asset specificity can be managed by the market; (2) without opportunism, *stewardship* can be used to replace hierarchy (since the parties can rely on each other for respect of the commitments); (3) without asset specificity, contestable markets in Baumol's sense can be defined. Cf., Pitelis (1991, p. 12).

[2] The demarcation line between market and hierarchy, as Williamson (1975, p. 130) observes, is problematic. Every organisational structure is associated with a package of costs and benefits with respect to the three categories of opportunism, bounded rationality and asset specificity, and the choice of an organisational structure implies the choice of the entire package of costs and benefits.

because in a context of costly transactions, neither can solve the whole allocative problem efficiently.

2. The definition of the problem

An initial problem of Williamson's market-hierarchies framework concerns defining the question of how to explain capitalist institutions. This definition, in Williamson's theory (and in NIE as a whole), is simply inherited from neoclassical economics (NCE). By discussing the neoclassical roots of NIE, our purpose is to demonstrate the apologetic aspect of assuming a system of pure markets as a theoretical starting point. Indeed, the necessity of assuming at least one institutional arrangement as a primordial condition stems directly from NCE's method of looking at institutions, but the identification of such a primordial system with the system of pure markets has no analytical explanation in NCE itself.

Within NCE, the problem of the general equilibrium (GE) framework is its inability to *explain* economic institutions: institutions can only be taken as given, but cannot be explained as the result of economic processes. Following the principle that economic institutions exist as means to achieve Pareto efficiency, the problem of the GE model is that the market is not the only allocative mechanism compatible with Pareto efficiency. Indeed, symmetrical to the completely decentralised model of the GE model, it is possible to define a completely centralised model and to formalise its allocative mechanism by the convex programming model. A well-known result in the comparison of the two models is that, from a pure efficiency point of view, they are equivalent: if they can give rise to different (optimal) allocations, this is only dependent on the preferences of decision-makers within their respective models (the objective function of the planner of the programming model and the individual preferences of the consumers of the GE model weighted by their respective budget constraints), not on the superiority of one allocative mechanism over the other. The equivalency of the two models can also be generalised to a system based on firms, as soon as one considers the firm as a micro-planned system.

These equivalency results imply that, in the GE world, if one accepts the principle that institutional arrangements emerge and evolve according to their relative economic efficiency, it is impossible to explain the configuration of the capitalist institutional system, in which different allocative institutions coexist. If one allocative mechanism is supposed to appear first, no other mechanism would arise.

Clearly, this does not mean that it is contradictory to *assume* a firm-based economic system. What is contradictory is to *explain* the firm once a different allocative mechanism has already been assumed. Thus, the problem of the nature of the firm in a GE world is a false one: firms, planning and markets are all perfectly consistent with the features of the GE world. It is obvious, however, that the organisational structure of the system is an assumption, not a result of the analysis. The economic system defined is a purely abstract and a-historic construction; no process can be called upon to explain the emergence and developments of the institutional system assumed.

Hence, the use of comparative statics leads to the conclusion that, in the GE world, the problem of the nature of institutions should either not be posed at all (since their existence must be assumed and cannot be derived); or else it should be posed for all of them (since there is no asymmetry among them, each of them being redundant as soon as another is assumed).

Given the equivalency results obtained in the GE world, NIE distances itself from the GE framework, arguing that the features of such a theoretical world are unrealistic. By questioning the basic assumptions of the GE world (perfect information, certainty and full rationality), NIE defines a context in which allocative mechanisms are not equivalent. And, by using the efficiency principle as the engine of evolution, it provides an *explanation* of the coexistence of different allocative mechanisms (planning, firms and markets) as solutions to specific allocation problems in which each respective mechanism is the most efficient.

This definition of the problem provides a narrow perspective on the concept of institutions in NIE just as in NCE. *The* economic problem is defined in terms of the allocation of scarce resources, and economic institutions are considered only for their allocative properties. In this way, the *nature* of capitalist institutions is defined in efficiency terms, as a comparison between allocative mechanisms. In the GE world, the equivalency result leaves the problem undetermined. In the NIE world, instead, general equivalency theorems do not hold, and this allows NIE to adopt comparative statics coherently as a method of evolutionary analysis. In the GE world, all institutional arrangements are assumptions; in the NIE world, institutional arrangements can instead be derived by means of exercises in comparative statics provided that one initial institution is assumed to pre-exist.

The fact that, with comparative statics, the final institutional configuration does not depend on the initial conditions means that any institutional arrangement can be taken as the theoretical starting point. But, then, why the market?

The problem is twofold: first, by assuming the existence of one primordial institution in capitalism, Williamson fails to explain it and then makes it universal; second, by identifying this primordial institution with the market, he inevitably falls into a sterile idealisation of this institution. Had Williamson assumed an initial starting point of pure planning or of a mixed institutional set-up, he would have been unable to explain some institutions of capitalism and the project would have been contradictory anyway. But, the problem is that the choice of the market as a natural institutional arrangement is also apologetic, since it idealises the market, transforming it from a historically defined institution into a universal category. And this process of idealisation occurs without any clear analytical justification.

3. The method

Let us analyse Williamson's method of demonstrating the efficiency of capitalist institutions. His theory is based on the assumption that, starting from a system of pure markets, if human action is spontaneous, then social interaction is Pareto efficient. But, first, spontaneous action is not sufficient to prove, under general conditions, that the outcome of social interaction is Pareto efficient. Second, the use of comparative statics as a method of historical analysis creates more problems than it solves: the efficiency of capitalist institutions is not argued historically but deduced from the assumption that in the initial conditions 'natural endowments' are distributed heterogeneously.

Williamson's methodological assumption that in the beginning there were markets was not problematic so long as it was explicitly set out in a comparative statics context. Outside such a context, the initial conditions matter. Williamson's attempt to solve the historical problem in a purely deductive way creates interpretive problems. At best, historical examples are chosen *ad hoc*; in other cases, they are simply *assumed*.

3.1 Initial conditions and the efficiency of capitalist institutions

Consider the problems that originate by shifting from comparative statics to dynamic analysis in Williamson's theory. This change of method is developed immediately after the construction of the market and hierarchies framework. Williamson thereafter uses his framework to explain a number of historical processes.

As far as method is concerned, Williamson's historical analysis is peculiar: the statement that capitalist institutions originated without coercion is not documented historically, but argued deductively. He does not investigate what has effectively taken place, but analyses the conditions that make an institution efficient and from this *deduces* the historical emergence of such an institution:

> *Suppose* that adaptations to changing market circumstances are needed in order to utilize resources efficiently. While a full group discussion could be held to determine what adaptation is to be made, this is time consuming and may yield little gain [. . .]. Authoritative assignment of decision-making responsibility to the occupant of the center *is* again *indicated*. (Williamson, 1975, p. 47; italics added)

The internal division of labour of a hierarchical structure is itself explained, deductively, by assuming particular starting conditions, such as 'unequally distributed administrative talent', 'oratorical gifts', 'information processing', 'decision-making skills', etc. (Williamson, 1975, pp. 47–52). His argument makes use of the heterogeneity of individual natural endowments, but such heterogeneity is not investigated, it is taken for granted.

But, even conceded that endowments are heterogeneous, the fact that they are the *cause* of hierarchy must be argued historically. Even if one claims that heterogeneous endowments can *cause* hierarchical relations, one must still discuss the circumstances that make such a cause unique, i.e., to show that no other element influences the emergence of hierarchies (both in the sense of promoting and hindering it).[1]

Williamson's analysis is weak also on strictly analytical grounds. His theory states that, if human action is voluntary, every institution that *might be* improved would not survive for long in its inefficient form, since it would *effectively* be improved. However, scholars who reject this equation of evolution-efficiency have convincingly criticised such a statement.[2]

In order to analyse the internal consistency of Williamson's theory, we can limit the discussion to the criticism compatible with methodological individualism (to which Williamson adheres). In this context a well-established result is that path dependency is sufficient to produce inefficient outcomes.[3] Indeed, Williamson, by focusing exclusively on a context of positive transaction costs, has failed to grasp an important result much discussed in the context of zero transaction costs (and valid *a fortiori* with positive transaction costs), namely the Pareto inefficiency of competitive equilibria in the presence of market failures (increasing returns to scale, externalities, public goods) and in situations such as the so-called *prisoner's dilemma*.

In sum, Williamson's analysis of capitalist institutions is a mix of wrong hypotheses and weak logical-deductive rigour. This is the price Williamson is ready to pay to provide a

[1] In NIE, the definition of the market as the arena of free interactions and the contrast with other capitalist institutions (the firm, in particular) characterised by hierarchical relations inevitably raises the issue of power. The tensions that the different streams of NIE face in their attempt (1) to theoretically characterise the firm as distinct from the market and (2) to provide a picture of capitalist institutions as involving no power relations are discussed in Palermo (2000).

[2] This idea that institutions evolve based on efficiency criteria, and that therefore prevailing institutions exist because they are efficient, is common in NIE. For a synthesis of the arguments of the evolutionary school against this equation of evolution and efficiency, see Hodgson (1994).

[3] Ullmann-Margalit (1978), for instance, has shown that Pareto efficiency is neither necessary nor sufficient to survival. Path dependency can also produce inefficiency in the technical sense: the case of the spread of QWERTY keyboards in computers notwithstanding their technical inefficiency (once abandoned the mechanical technology of old typewriters) is perhaps the most quoted example. Cf., David (1985).

picture of the existing institutional set-up as a Pareto-efficient solution to preconceived allocative problems.

3.2 Economic history versus 'as-if economic history'

It is noteworthy that, on the basis of his comparative statics framework, Williamson (1975, 1980, 1985, 1996) does engage in the *historical* debate on the origins of hierarchy. His arguments address the work of Pollard (1965), for example, which stresses the need for hierarchical management and control in the light of technological developments and the factory system. Specifically, Williamson criticises the work of the radical political economist Marglin (1974). Williamson (1996) argues that power-oriented explanations of firm-hierarchy have less explanatory value than the efficiency explanation entailed in transaction cost theory.

But since his arguments are conducted deductively rather than historically, Williamson is forced to *invent* a course of history whose realism and grounding in historical events is immaterial to the validity of the model. 'Predictive power', rather than historical accuracy, seems to drive the argument (cf., Friedman, 1953). As a method of history, this comes close to being absurd, since the validity of our knowledge of the past cannot, by definition, be its predictive power.[1] The only way out of this dilemma for Williamson would be to assume that the same operative mechanisms have been ubiquitous throughout history, which he does. This leads to serious tensions in his historical account.[2]

Effectively disregarding serious historical research, Williamson is forced to tell a story that simply tries to fit his theory. He does not try to explain actual events, but only illustrates, *at best* (but probably not!), a *possible* historical development. The story does not start with 'once upon a time . . . ', but with 'let us assume that the world is *as if* it were coherent with our theory . . . '. In Williamson's theory, as in NIE at large, history is treated as if it did not matter to the conception of the model; rather, history is 'as-if' to the validity of the model. But, since hierarchical organisations of production in history preceded a system of markets, feudalism preceded capitalism, the labour market, proletarisation, etc. are historical products, the assumptions of Williamson's theory inevitably land him in trouble. In order to solve the problem, Williamson depicts micro-economically rational agents *selecting, voluntarily through conscious choice,* markets over hierarchy, capitalism over feudalism, wage-labour over serfdom, by calculating their respective efficiency.[3] But there is a tension in this account of both rational choice and selection arguments of efficiency. If markets are assumed to exist *prior* to selection, nobody historically could have chosen them for their efficiency (i.e., the market cannot be explained from an efficiency point of view). Alternatively, if markets are seen as consciously chosen, markets cannot be seen as the unintended, 'spontaneous' result of evolution, of a societal 'natural selection'. Williamson is caught in the middle. The first argument maintains bounded rationality, and efficiency is guaranteed

[1] This argument in relation to the 'as-if economic history' of NIE is developed in Ankarloo (2002).

[2] Particularly noteworthy is that Williamson as well as NIE at large (including Cheung (1983), Alchian and Demsetz (1972), Stiglitz (1975)) contends that firm-hierarchies and wage-labour were voluntarily selected by workers for efficiency reasons. But although historians of labour relations and firm-hierarchies differ in method and theoretical explanations of these phenomena—whether Marxist, like Thompson (1978, 1993), Hobsbawn (1964) and Rule (1986), or power oriented, like Marglin (1974, 1991), or technology oriented, like Landes (1969), Berg (1984, 1991) and Pollard (1965), or even influenced by post-structuralist deconstruction, like Berlanstein (1993)—they all seem to converge on the point that capitalist hierarchies were imposed on workers and entrepreneurs alike, with ample resistance from workers and independent producers and without any of the 'voluntary exchanges' depicted in the fairytales of NIE.

[3] This is characteristic of property rights theory as well as the institutional economic history of Douglass North. See above all North and Thomas (1973) and North (1981).

through selection. Faced with the criticism that this argument is theoretically unsound and historically false, Williamson recurs to the omnipotent rational economic man, and when this is duly criticised, he comes up again with bounded rationality and selection.[1]

Williamson tries to solve these dilemmas by escaping from them. Markets are everywhere. Capitalist micro-rationality is a universal trait of human beings (even in the absence of prices and markets). But his assumptions are not historically founded and true only *for* the capitalist system. They remain inadequate for explanations of other systems and for the explanation of the transition *to* capitalism. Hence, in NIE the problem of how to explain the transition to capitalism is not solved but *dissolved.* But granted the fact that capitalism — including capitalist markets and firms—is a result of history, the market too should be considered as a consequence, not the cause of historical development.

The 'as-if economic history' of Williamson's approach is a-historical and, accordingly, his selection argument is bound to fail.

3.3 Theory, reality and history

The assumption of a system which never existed and the story of processes which never happened make the understanding of the real system problematic. It is only by starting from the inspection of real pre-capitalist systems that we can, by means of analysis, understand the theoretical nature of real capitalist systems. If, on the contrary, we start our evolutionary analysis by assuming an imaginary system, we cannot but end up with the theoretical understanding of an imaginary world. If we want to understand reality, the hypotheses must be founded in reality. Otherwise, we understand a system which is purely ideal and has no relation with the object of our investigation, the institutions of capitalism.

Whatever may be the engine of institutional change, we would expect present institutional arrangements to be the product of the evolution of preceding arrangements. But if we assume a primordial *ideal* system that has never existed, we prevent ourselves from understanding the *real*, actual system. Only if the historical facts that preceded the advent of capitalism were totally irrelevant for the establishment of capitalist institutions would the choice of the primordial institutional context not be a problem for the analysis of capitalist institutions.

And, even though in non-capitalist societies markets do not exist or, at best, play a very subordinate role in economic life, in Williamson's conception, markets are ubiquitous. Instead of attempting to understand actual society as a result of the evolution of preceding societies, he goes the other way round, understanding the past as if it had worked according to the same principles as the present. He tells a story of capitalism as if its mechanisms and principles were always present. But, as this is not true, Williamson is obliged to move away from history and to invent a (false) story whose point of arrival is the actual institutional system. The hypothesis that markets have always existed is then inevitable. This method of explaining capitalist institutions is based on the construction of a story which fits the theory. The attempt thus is to *define* reality in accordance with theory, not to provide a theory that explains reality.

The attempt to explain institutional evolution with the specific categories of the capitalist institutional system leads to a reading of the history of human society as a history *of* capitalism, not as the history that leads *to* capitalism (and, perhaps, to its overcoming).

[1] Granovetter (1985) and Hodgson (1991) provide criticisms of the Panglossianism underlying Williamson's theory. Williamson (1987, p. 623) calls this accusation a 'red herring' and has recourse to rationality explanations again (cf., Williamson, 1996).

4. The underlying conception

In order to clarify the conception of capitalist institutions that Williamson's framework entails, we scrutinise the 'convenience' of the assumption of that 'in the beginning there were markets' from the viewpoint of its internal consistency. We start by noting that the market is an institution that NIE does not even try to explain.[1] It is considered a natural category from which all other institutions are to be derived. The market is a primordial concept and does not require explanations. As Dugger (1992, p. 89) observes:

> The neoclassical market is an act of God, not an act of man. It is natural rather than artificial. (. . .) The natural market is beyond the will of humans. It is a product of nature existing outside of history. (. . .) But the spontaneous market, the natural market, is an assumption. It is not a unit of enquiry, something to be investigated. Instead it is something to be assumed, taken for granted (. . .) the market is taken as the only real circulation process and the market is simply assumed to exist. It is viewed as a self-generated phenomenon, a product of immaculate conception and virgin birth.

As we have seen, when using comparative statics Williamson renounces the general objective of *explaining* the institutions of capitalism: he can explain all but one, on the basis that at least one of them must be assumed. Now, the question is: can the market be considered a coherent starting point?

The assumption of pre-existing markets in the analysis of capitalism is as old as the history of political economy. Not much younger is the tradition of criticism of such an assumption elaborated by the Marxian school. Engels notes: 'Production may occur without exchange, but exchange—by the very fact that it is only an exchange of products—cannot occur without production' (Engels, 1976, p. 186).

This distinction between exchange and production is also addressed by Fourie (1989, 1991, 1993). He too argues that exchange presupposes production. So, logically, the firm precedes the market, not vice versa. Otherwise there would be nothing to exchange. Fourie (1993, p. 44) says:

> Firms can exist without markets, i.e. without barter or trade. However, a market, unlike a firm, cannot produce. Therefore market relations can only *link* firms (producing units). (. . .) Markets and firms are not alternative modes of production, but are inherently and essentially dissimilar. (. . .) Therefore, although some firms may in practice be formed or adapted in order to eliminate or avoid market (exchange) transactions, *the emergence and existence of the firm as such—of all firms—cannot be explained by transaction cost considerations*.

Therefore, the idea that the market is the original institution is inconsistent: markets cannot exist without institutions that solve the production problem.[2]

Hodgson (1993, pp. 81–2) points out, however, that Coase's and Williamson's definitions of the firm exclude individual production. Williamson's pure markets system is, in fact, a system of individual productive units (which, in his terminology, are not called firms, since his definition of the firm is based on the work contract). If this is granted, then it is not correct to affirm that the production problem is not defined in Williamson's world; it exists, but it is not discussed. The main reason why the theory is unsatisfactory is not that a pure market system is inconsistent since *markets do not produce*, but that it presupposes the exist-

[1] Hodgson (1988, pp. 177–82) points out that NIE has focused on the problem of the nature of the firm without raising the problem of the nature of the market.

[2] Even North (1981, p. 41) points out: 'All the modern neoclassical literature discusses the firm as a substitute for the market. [This] ignores a crucial fact of history: hierarchical organization forms and contractual arrangements in exchange predate the price making market'. See also Dietrich (1994, p. 17).

ence of *some* production units, which are never analysed. To put it differently, exchange cannot exhaust the investigation of capitalist institutions.

So, at the very starting point of Williamson's theory, one major aspect of the firm is conspicuously absent: the fact that the firm is a *production unit* (Fourie, 1989, 1993; Sawyer 1993; Dietrich, 1994). Even in the absence of transaction costs, there would still have to be some *production* unit which is not a market, e.g., family, clan or firm. To separate the market and the firm analytically, we argue that the *firm* must be seen as a production *organisation.*[1] This is of some importance, because it then becomes impossible to analyse one mode of coordination, an organisation—the firm—solely in the light of a qualitatively different mode of coordination, an institution—the market (Fourie, 1993; Dietrich, 1994). Rather than explaining an organisation in the light of an institution, one should explain an organisation in the light of other organisations.[2] And it is here that the convenience of Williamson's original formulation fails.

As Hodgson (1993) has suggested, Coase's original formulation only relates to the origin of the 'capitalist' firm. Therefore, what is at stake is explaining the specific contract relation between capital and wage-labour.[3] But in this case, the problem is not one of market or hierarchy, but of different kinds of hierarchies.[4] The relevant question is not how the firm substitutes for the market, but how the capitalist firm substitutes for alternative hierarchical production units (e.g., the manor system, family production, the putting out system, etc.).

Williamson argues instead that all the economic institutions of capitalism are constructed to solve the same problem: *the allocation of scarce resources.* There is *the one* economic problem and a number of instruments—economic institutions—to solve it. The necessity of resorting to different instruments depends on the assumption of a complex world in which each of them may fail. The relation among the institutions of capitalism is thus one of pure *substitution*: the space reserved for one institution cannot help but be taken over by other institutions. The coexistence of different institutions is presented as a problem of *balance* among different instruments. Were we to assume away the reasons for their failures, a single-institution-system would become perfectly consistent.

To explain the existence of the trinity of market—firm—state in a comparative statics framework of one substituting for the others makes sense only if we view them in terms of the functions they can perform. And although they share one common feature in that they all can allocate recourses, they differ in many qualitative ways. The perspective of substitution is therefore narrow and misleading. Hence, once we recognise that the state and the firm also perform very different functions from the market, they cannot be explained just as substitutes for the market.

If, then, we recognise that the allocation function cannot be performed if other functions are not taken care of, the idea itself of a single-institution system is inconsistent. In this case, it is necessary to assume (and to investigate) other institutions capable of working out the tasks required to carry out the allocation function. If, also, we recognise the qualitative differences among the market, the firm and the state (the market *exchanges*, the firm *produces*, the state *regulates* both exchange and production), they cannot be explained solely as substitutes for one another. Rather, these institutions are necessary complements to one

[1] A very good exposé on these questions and their theoretical importance to NIE is given in Khalil (1995).

[2] As Khalil (1995, p. 454) puts it: 'Thus the theory of institutions cannot fulfill the role of the theory of organisation.'

[3] Hodgson (1996, p. 3) relates a private correspondence with Coase on the matter, where Coase admits that: 'the firm I was talking about was undoubtedly . . . "the capitalist firm".'

[4] As Pitelis (1993, p. 269) points out: 'All employment relations are hierarchies (. . .) From the point of production (the employment relation) the market itself involves hierarchy.'

another. Without the others, one institution would not be sufficient to assure the working of the system (although, clearly, this does not exclude the fact that their functions can also overlap, giving rise to a substitution relation, too).

The conception of a primordial system of pure markets is internally inconsistent, because the working of the market itself requires the existence of other (non-market) institutions, which in turn cannot be *explained* as solutions to market failures. The origins and evolution of the state, the firm and the market must thus be investigated jointly, since the three phenomena are interrelated. Here, history is needed for theoretical consistency in the first place, since evolutionary arguments only make sense in relation to what actually happens.[1]

5. A Marxian answer

In order to overcome the contradictions and inconsistencies of Williamson's theory, we sketch a Marxian approach to the problem of the nature of capitalist institutions. We do this by further deepening the analysis of the NIE starting point, the 'convenience' of the assumption of 'in the beginning there were markets' and by pointing out the necessity of analysing the historical circumstances that led to the formation of the economic institutions of capitalism: the separation of producers from the means of production and the formation of the labour market. These are the preconditions that explain the emergence of the capitalist firm.

5.1 The conflation of market with simple barter

A first problem to consider is what the conception of primordial markets really means in Williamson's framework. What is a market in this conception? And *which* markets are assumed to exist? Such questions are essential to the understanding of Williamson's framework and to overcoming its theoretical limits.

Acknowledging the fact that an essential characteristic of the market is 'exchange' (of commodities or 'property rights' over assets), we argue that not all exchange can be assumed to be market exchange (we exchange presents at Christmas for instance).[2]

Therefore, a possible formulation of the assumption would be 'in the beginning there was exchange'. But 'exchange' is then either (1) separated from the specific kind of exchange of commodities, property rights over assets or (2) simply conflated into one, to 'all exchange is market exchange'. If we start with the second case, we note that it becomes difficult for Williamson to explain the institutions of capitalism, because the commodity form of assets is a result of societal (capitalist) *production*. This is not very convenient to Williamson at all, since it already assumes what is to be explained.

So, let it be the first case: 'in the beginning there was (non-market) exchange'. This is the starting point of 'truck and barter' in Adam Smith. And here emerges the crux of the matter. The 'markets' that Williamson assumes are not actual or real markets, they are not the markets of commodity exchange under capitalism, i.e., they are not capitalist markets at all, but *neoclassical* markets as those of the GE world. This is of decisive importance, because what is assumed in this interpretation is simple *barter* rather than market exchange. From such a formulation, the specific *capitalist* market needs to be *explained* before we can even begin to explain hierarchy. Williamson does not even attempt to do this.

[1] This is the context dependency argument of evolutionary biology. Cf., Sober (1987) and Hodgson (1991).

[2] In NIE nowadays it is also granted that many transaction costs, the 'costliness of exchange', arise within firms. Cf., Barzel (1989), North and Wallis (1994).

However, the qualitative differences between barter and market exchange are several. For example, in barter (as in the neoclassical market) things exchange for things, i.e., demand and supply—selling and buying—are simultaneous. Money is just a 'veil' or is introduced *ad hoc* as a 'convenience'. In everyday capitalist markets, however, demand is not shown in supply, but with money, i.e., buying and selling are not simultaneous. The individual first sells (either a commodity or labour-power) to obtain money and, then, with this money, *as a separate act*, he buys the commodities he needs. This is also the reason why money, a 'universal equivalent', is a structural *necessity* in capitalist markets (not solely a glued-on 'convenience' in the theory). This is another feature that separates barter from exchange on the market and neoclassical markets from capitalist ones (cf., Freeman, 1996, pp. 20–2). Furthermore, as Marx noted:

> Exchange has its own history. It has passed through different stages. There was a time, as in the Middle Ages, when only the superfluous, the excess of production over consumption, was exchanged. There was again a time when not only the superfluous, but all products, all industrial existence had passed into commerce, when the whole of production depended on exchange. How are we to explain this second phase of exchange . . . ?[1]

This formulation of 'in the beginning there was non-market exchange' then becomes a non-starting point, simply vacuous in analytical terms, for the purpose at hand. How are we to derive the institutions of capitalism—commodity production, market exchange and the origins of hierarchy—from such an empty formulation? Are we to conclude that all capitalist market exchange was already contained in all previous non-market exchanges? Was the first exchange ('the fall of man') the seed to the capitalist market society, the society Williamson wants to explain?

From a Marxian point of view, we suggest that Williamson's assumption can only conceive of exchange as something 'accidental' rather than necessary, as an expression of individual 'will' and convention, rather than as a structural necessity.[2] But, in capitalism, it is no 'accident' that people first go to work Monday morning, and then, with money, go to the supermarket to buy the necessities of life.

However, even remaining within the confines of the exchange-point of view underlying NIE, the problem is that NIE cannot uphold the separation of a society in which exchange is the driving force, the everyday form, the life-blood, of the economic system, from one in which it is not. From this exchange-point of view, this central function of the market is what separates capitalism from other systems. The evolution of a specifically capitalist market from a system where the market is not central cannot even begin to be explained in Williamson's framework. For the purpose of explaining capitalist firm-hierarchies, his assumption is therefore vacuous.

To deal with this point fully, we must deepen our analysis to include the labour market and production.

5.2 The commodification of labour power and the social dimension of production

Does 'in the beginning there were markets' include the labour market too? Again, Williamson is in trouble. If we include labour markets in the assumption, by definition, employment relationships (i.e., hierarchies) are assumed too, and cannot therefore be explained from the

[1] Marx (1847, ch. 1.1, pp. 2–3)

[2] Cf., Marx (1964, pp. 106–7): 'As to how far the external and apparently accidental circumstances are but the expression of a necessary course of development, political economy teaches us nothing. We have seen how exchange itself appears to it as an accidental fact.'

assumption. If, on the other hand, labour markets are not assumed (to save the idea that hierarchies are not assumed), we must first explain the evolution of labour markets, how market exchange leads to labour market exchange. It is only in the presence of a labour market that the formulation of 'in the beginning there were markets' could lead to capitalist firms and its complex organisational structures. Again, Williamson's framework cannot solve this problem because, within this framework, the problem cannot even be recognised to exist. This, as we have suggested, is also linked to the fact that if what is assumed is not the capitalist market but the neoclassical market, *a fortiori*, what is being explained is not the capitalist firm at all, but the *neoclassical* firm.[1] As we have argued, the question of its existence in the GE framework is a false question.

But, conceivably, there is another possibility: to view hierarchy as the alternative to isolated individual producers linked by market relations. Hence, the alternative to hierarchy is a system of self-employed producers buying and selling their products, but not their labour power.[2]

However, this approach is problematic because of the conception of production it implies. Strictly speaking, production would be an activity *separated* from society; something that takes place *before* human beings enter society via commodity exchange. This is hard to grasp as *human* production at all. And it is hard to see how these eremites in production could be integrated by such a sophisticated mechanism as the market. All individuals cannot produce on their own in individual production at the same time, even in theory. That would simply be no *societal* production at all. If in reality a single individual can do this, it is because of the level of social integration within society itself. This conception of 'self-employment' and individual production underlying Williamson's conception of markets without hierarchies in actuality *presupposes* the most complex social integration. It *presupposes* all the things he wants to explain.[3] Marx (1973, p. 84) summarises the point:

> Only in the 18th century, in civil society, do the various forms of social connectedness confront the individual as a mere means towards his private purposes, as external necessity. But the epoch which produces this standpoint, that of the isolated individual, is also precisely that of the hitherto most developed social (from this standpoint general) relations. The human being is in the most literal sense (. . .) an animal, which can individuate itself only in the midst of society. Production by an isolated individual outside society (. . .) is as much of an absurdity as is the development of language without individuals living together and talking to each other. There is no point in dwelling on this any longer. The point could go entirely unmentioned if this twaddle (. . .) had not been earnestly pulled back into the centre of the most modern economics . . .

This starting assumption becomes more or less equivalent to 'no production in society at all'. This is where we arrive if we take Williamson's starting point to its logical conclusion. Williamson's starting point does not necessarily deny the division of labour in society—integrated by the market. But if he allows such division of labour at the starting point, this labour has to be conducted within some social organisations, such as family, individual

[1] This is also noted by Lazonick (1991, p. 184).

[2] See also Coase (1993) and Hodgson (1993).

[3] Indeed, 'self-employment' *qua* employment is a capitalist, or at least hierarchical, concept to start with. Marx (1969, pp. 407–9) analyses this phenomenon as regards independent production of handicraftsmen and peasants under capitalism. He holds the views that: 'the independent peasant or handicraftsman is cut up into two persons', that he: 'exploits himself as a wage-labourer', and that the reason: 'that he is able to appropriate for himself the whole product of his labour (. . .) he owes not to his labour–which does not distinguish him from other labourers–but to his ownership of the means of production.' In short, self-employment is both exploitative (extraction of surplus value) and hierarchical, *but only given capitalist relations of production generalised in society as a whole.*

business (self-employment) etc. Hence, as said, firms arise as alternatives to these organisations, not in relation to the market at all.

At bottom, Williamson reproduces the old fancy of economic thought from the age of classical political economy that the individual and his individual production are non-social phenomena and that cooperation is the social mystery to be explained.[1] But this conceptualisation of the original individual, and the attempt to derive social relations from his 'self-interest', starts from an assumption which makes him not social and societal at all. We can only be self-interested, egotistic individuals *in* society, in relation to other human beings, within institutional frameworks not outside them. Hence, social relations cannot simply be derived from a socially immutable, 'self-interested', human individual. Again Marx (1973, p. 156):

> The point is rather that private interest is already a socially determined interest, which can be achieved only within the conditions laid down by society and with the means provided by society (. . .) It is the interest of private persons; but in content, as well as the form and means of realisation, it is given by social conditions independent of all.

The problems Williamson's framework runs into do not arise in the Marxian conception of the economy as a 'mode of production'. In this conception, not only is the economy defined in a social and historical manner, but capitalism appears as a specific economic system (as opposed to universal), as the historical result it is; as the result of 'divorcing the producer from the means of production', a divorce, 'written in the annals of mankind in letters of blood and fire' (Marx, 1967, pp. 714–15). Its essence is commodity production based on wage-labour and capital. With this conception, production and allocation of resources can be analysed in a coherent fashion. As Marx (1973, p. 156) has put it:

> Prices are old, exchange also; but the increasing determination of the former by the costs of production, as well as the increasing dominance of the latter over all relations of production, only develop fully and continue to develop ever more completely in bourgeois society, the society of free competition. What Adam Smith, in the true 18th century manner, puts in the prehistoric period, the period preceding history, is rather a product of history.

6. Conclusions

We began our critique of NIE by analysing the way in which it poses the problem of understanding the nature of capitalist institutions. Having shown that the market is not the only institution that can be used as a primordial condition to explain the institutions of capitalism, it is clear that Williamson's enhancement of precisely the market to a natural and universal category is purely ideological. Williamson's research programme, aimed at presenting the institutions of capitalism as an expression of the highest principles of rationality, is an operation of pure apologetics. Furthermore, it is apparent that his definition of the problem is not scientifically warranted, but is itself an expression of ideology produced by capitalism. His definition stems from a process of superficial idealisation of reality, not from a deep-going examination of the history and logical relations of capitalist institutions.

The as-if method of historical analysis does not even try to *explain* the present as the result of the processes of the past; instead, it *assumes* the past in order to make the present appear

[1] Cf., Marx (1969, p. 409): '*Separation* appears as the normal relation in this society (. . .) in this society unity appears as accidental, separation as normal; and consequently separation is maintained as the relation even when one person unites the separate functions.'

Pareto superior. Economic historians, in their attempt to explain the course of history, provide a picture of the present made up of contradictions, conflicts, convergences and divergences. Williamson, and NIE, instead assume that the present is a coherent expression of rationality and efficiency and invent a story whose logical end is indeed the existing reality. So, what for historians are contradictions and compromises become for NIE the conditions of consistency. This implies that the stories told by economic historians on the one hand and by NIE on the other go in opposite directions: from the past to the present in the first case, from the present to the past in the second. Economic historians try to explain history, NIE, instead, tells a fairytale whose happy ending is the present.

With this peculiar definition of the problem and method for its resolution, NIE inevitably focuses on a very specific aspect of the relations among the institutions of capitalism: the partial substitutability of certain institutions in performing their allocative function. This conception of capitalist institutions limits their economic role to that of pure resource allocation and obscures the fact that the problem of resource allocation can be defined (and solved) only if other functions are performed (production, in the first place, but also regulation of both production and exchange). This means that the nature of capitalist institutions cannot be understood simply by discussing their substitutability in resource allocation, but requires an examination of their complementary roles in the working of capitalism.

Looking at the problem from a Marxian perspective, it is also possible to explain why Williamson can come up with his original formulation; because in capitalist society the individual *appears* as detached and in this society production *appears* to be the consequence of market exchange (on the labour market). But these illusions are themselves a consequence of capitalism. They are the products of the economic realities of capitalism, not the producer of these capitalist realities. Even the appearance that markets are natural and universal is ultimately a consequence of ideology produced within capitalism; and the attempt to depict the institutions of capitalism as necessarily efficient is just part of an apologetic rationalisation of the status quo, which transforms a complex historical reality into an everlasting truth. Hence, Williamson himself is an institution of capitalism.

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